No. 93-1993

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United States

OCTOBER TERM, 1993

IN RE WELLS FARGO SECURITIES LITIGATION

WELLS FARGO & CO., *et al.*,
Petitioners,
v.
HOWARD GREENWALD, *et al.*,
Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

The Ninth Circuit's opinion in this case sets forth a pleading standard for securities fraud complaints that is radically different from the standard used by other circuits. Respondents do not seriously dispute the existence of this inter-circuit conflict, but seek to trivialize it. However, the inter-circuit conflict presented by this case is not, as respondents would characterize it, "nonexistent or minimal." The conflict is of serious and immediate concern to litigants in the Ninth Circuit and elsewhere.

I. THE NINTH CIRCUIT'S OPINION CREATES AN INTER-CIRCUIT CONFLICT OVER THE REQUIREMENTS FOR PLEADING SCIENTER.

Respondents' baseball analogy demonstrates that securities fraud plaintiffs are playing by one set of rules in the Ninth Circuit, and a different set of rules in other circuits. A complaint alleging that corporate officers were motivated to defraud corporate shareholders by their desire to keep their jobs and earn more money is a ball at Wrigley Field, Shea Stadium and the Astrodome, and is now a strike at Candlestick Park.

The Second Circuit recently joined the Fifth and Seventh Circuits in explicitly rejecting the Ninth Circuit's holding in this case. In *Shields v. Citytrust Bancorp, Inc.*, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,239 (2d Cir. June 2, 1994), plaintiff claimed that Citytrust overstated its earnings by understating its loan loss reserves. The Second Circuit affirmed dismissal of the complaint on the ground that the allegations did not raise an inference of scienter. The Second Circuit rejected plaintiff's claim that a motive to defraud could be inferred from defendants' desire to "protect their executive positions and the compensation and prestige they enjoy thereby." *Id.* at 99,655. The Second Circuit concluded:

> To allege a motive sufficient to support the inference that optimistic but erroneous statements were fraudulently made, a plaintiff must do more than merely charge that executives aim to prolong the benefits of the positions they hold. . . . If motive could be pleaded by alleging the defendant's desire for continued employment, and opportunity by alleging the defendant's authority to speak for the company, the required showing of motive and opportunity would be no realistic check on aspersions of fraud, and mere misguided optimism would become actionable under the securities laws.

Id. See also Tuchman v. DSC Communications Corp., 14 F.3d 1061, 1067-69 (5th Cir. 1994); *DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir.), *cert. denied*, 498 U.S. 941 (1990).

The Second Circuit in *Shields* noted that plaintiff, represented by some of the same attorneys representing respondents in this case, urged the Second Circuit to adopt the "less demanding view of the pleading requirements in securities fraud cases" articulated by the Ninth Circuit in this case. The Second Circuit "decline[d] the invitation," concluding that the *Wells Fargo* decision was not "consonant with case law in this Circuit." [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,239, at 99,656.

Shields also rejected the two allegations respondents now proffer in a vain attempt to bolster the scienter element of their 10b-5 claim. First, respondents refer to the allegation in their complaint that on June 10, 1991, "the Company dismissed the claim that Wells Fargo might face a possible increase in non-performing real estate loans for the second quarter of 1991. Rather, the Company noted that for the past 16 years, Wells Fargo averaged only 0.13 of a percentage point in real estate lending losses." (a-55). Respondents also refer to defendants' failure to explain the stock price drop on June 24. Respondents contend that the juxtaposition of these public statements with the announcement of the increased loan loss reserve on June 25 supports an inference of scienter. Importantly, the Ninth Circuit *did not rely on either allegation* in holding that the complaint satisfied the scienter requirement. But even if the Ninth Circuit had held these allegations sufficient to support an inference of scienter, that holding would conflict with *Shields* and other out-of-circuit authorities.[1]

The Second Circuit rejected similar allegations in *Shields*. Plaintiff there alleged that defendants announced that Citytrust was expecting 1989 to be its twelfth consecutive year of record earnings just two months before it announced that it would report a loss for 1989 as a result of an increase in its loan loss reserve. The Second Circuit concluded: "This technique is sufficient to allege that the defendants

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1. In addition, respondents' contention makes no sense as a factual matter. The complaint contains no facts suggesting that either statement was false, much less made with the requisite scienter. Nowhere do plaintiffs allege that nonperforming real estate loans in the second quarter exceeded the bank's past experience, nor do plaintiffs allege how or why these statements support the inference that the loan loss reserve three months earlier was fraudulently understated.

were wrong; but misguided optimism is not a cause of action, and does not support an inference of fraud." [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,239, at 99,654. The Seventh Circuit agreed in *Arazie v. Mullane*, 2 F.3d 1456, 1467-68 (7th Cir. 1993), concluding that "temporal proximity between positive statements stressing a firm's strengths and announcements of poor economic performance do not create an inference that the earlier statements were fraudulent." *See also Tuchman*, 14 F.3d at 1069.[2]

Second, respondents contend that their allegation that defendants were motivated to inflate Wells Fargo's stock price in order to "squeeze" short sellers of the stock supports an inference of scienter. Once again, the Ninth Circuit does not even mention this allegation in its opinion, much less rely on it. And if the Ninth Circuit had relied on this allegation, it would have been in conflict with *Shields*, as well as other out-of-circuit decisions rejecting claims of "motive" unless a concrete economic benefit can be or has been gained by the fraud. *See, e.g., Shields*, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,239, at 99,655; *see also Tuchman*, 14 F.3d at 1068-69; *DiLeo*, 901 F.2d at 629.

It is of course true that when a stock price goes up instead of down, short sellers lose money. However, the complaint does not allege, and it defies logic to assume, that any defendant would benefit from "squeezing" short sellers of Wells Fargo stock. At best, the allegation invites the speculative inference that defendants engaged in securities fraud simply out of spite. "People sometimes act irrationally, but indulging ready inferences of irrationality would too easily allow the inference that ordinary business reverses are fraud. One who believes that another has behaved irrationally has to make a strong case." *DiLeo*, 901 F.2d at 629.

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2. Respondents' reliance on *Greenstone v. Cambex Corp.*, 975 F.2d 22, 26 (1st Cir. 1992) is misplaced. In that case, the First Circuit concluded that, under the facts alleged, it was *not* reasonable to infer that defendants "would have had to have known" certain facts before they became public.

II. THE NINTH CIRCUIT'S OPINION CREATES AN INTER-CIRCUIT CONFLICT OVER THE REQUIREMENTS FOR PLEADING A MISREPRESENTATION

The Ninth Circuit's holding that the statements of bank management's belief were actionable is also fundamentally inconsistent with decisions from other circuits. Neither the Ninth Circuit nor respondents' Opposition identifies a single allegation which, if true, would prove that management did not actually believe that the loan loss reserve was "adequate," and that certain HLT loans were "substantially secured." Again, a recent decision from another Court of Appeals highlights the inter-circuit conflict created by the decision below.

In *Serabian v. Amoskeag Bank Shares, Inc.*, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,228 (1st Cir. May 27, 1994), upon which respondents rely, the First Circuit applied a very different legal standard, examining the complaint to see if it contained particularized facts that were inconsistent with contemporaneous statements of management's belief. The complaint contained specific factual allegations that an outside consulting firm retained by the bank had reported "serious deficiencies" in the loan loss reserve, and that there had been internal reviews and audits concluding that increased reserves were urgently needed. These specific allegations were juxtaposed with the bank's contemporaneous public statements "characterizing its loan review capabilities as 'strong' and its ALL approach as 'conservative'." [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 99,559.

The First Circuit concluded that these facts satisfied the misrepresentation element of Rule 10b-5, and contrasted those specific allegations with the type of allegations the Ninth Circuit found sufficient in this case:

> In this series of allegations, plaintiffs do more than simply identify management problems or point to statements that put a positive spin on the company's circumstances, without indicating how or why defendants should have known the descriptions were inaccurate. Rather, these paragraphs present a con-

> trast between what company officials were hearing internally about their loan review effectiveness and the adequacy of their ALL, and what the company was telling the public *at the same time.*

Id. at 99,560 (emphasis in original).[3]

In *In re Time Warner Inc. Securities Litigation*, 9 F.3d 259, 266 (2d Cir. 1993), *cert. denied*, 114 S. Ct. 1397 (1994), the Second Circuit, applying the same legal standard as the First Circuit in *Serabian*, concluded that the absence of particularized facts inconsistent with management's stated belief was fatal to the 10b-5 claim. *See also Kowal v. MCI Communications Corp.*, 16 F.3d 1271, 1278 (D.C. Cir. 1994). In contrast, in this case the Ninth Circuit held that conclusory allegations, unsupported by any facts, that management did not genuinely believe the statements were true, were sufficient.[4]

III. RESPONDENTS' PROCEDURAL OBJECTIONS TO THE PETITION ARE MERITLESS

Despite these undisputed conflicts between the Ninth Circuit's opinion and decisions from other circuits, respondents seek to evade this Court's review by advancing two inconsistent arguments.

First, respondents argue that the Ninth Circuit's failure explicitly to rely on Rule 9(b) justifies denial of the petition, even though the Ninth Circuit discusses Rule 9(b)'s specificity requirement and pur-

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3. While *Serabian* does approve certain aspects of the *Wells Fargo* decision, the First Circuit incorrectly assumed that the *Wells Fargo* complaint explained how the named loans were connected to the alleged inadequacy of the bank's loan loss reserve. The First Circuit noted that the *Serabian* complaint referred to specific problem borrowers, but emphasized that "[t]he complaint does not allege a connection, however, between these specific loans and the asserted problems with internal monitoring and inadequate ALL." [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 99,561 n.11. Since the *Wells Fargo* complaint also fails to allege how the nine "bad" loans are connected with the alleged deficiencies in the bank's loan loss reserve, it appears that the First Circuit would have affirmed dismissal in this case.

4. Respondents do not dispute that by so holding the Ninth Circuit misapplied this Court's decision in *Virginia Bankshares, Inc. v. Sandberg*, 111 S. Ct. 2749 (1991).

ports to rely on other 9(b) decisions.[5] For that reason, and because the distinction between Rules 9(b) and 12(b)(6) is largely ignored in practice in securities fraud cases, lower courts are likely to construe *Wells Fargo* as a 9(b) case.

Moreover, the Ninth Circuit's holding conflicts with out-of-circuit decisions holding that similar complaints did *not* satisfy Rule 12(b)(6). For example, in *Shapiro v. UJB Financial Corp.*, 964 F.2d 272 (3d Cir.), *cert. denied*, 113 S. Ct. 365 (1992), the Third Circuit affirmed the district court's dismissal under Rule 12(b)(6) of portions of a complaint claiming a loan loss reserve at a given point in time was inadequate.[6] *See also Denny v. Barber*, 576 F.2d 465 (2d Cir. 1978) (affirming district court's dismissal of complaint for failure to state a claim under Rule 12(b)(6), as well as for failure to meet the requirements of Rule 9(b)).

Second, respondents suggest that it *may* be a waste of the Court's time to review the Ninth Circuit's opinion in this case because the conflict between the Ninth Circuit and other circuits *may* disappear when the Ninth Circuit issues its *en banc* decision in *In re GlenFed, Inc. Securities Litigation*, 11 F.3d 843 (1993), *reh'g en banc granted*, No. 92-55419, 1994 U.S. App. LEXIS 3331 (9th Cir. Feb. 25, 1994). To the contrary, the Ninth Circuit already refused to correct the inter-circuit conflict created by the *Wells Fargo* decision when it denied petitioners' petition for review of this case *en banc*.

Moreover, as respondents concede, the opinion below concludes that the complaint satisfies Rule 12(b)(6), and does not specifically discuss the requirements of Rule 9(b). Since the panel's opinion in *GlenFed* discusses only Rule 9(b), there is no assurance that the *en*

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5. For example, the Ninth Circuit opinion rejects defendants' argument about the allegation regarding the nine loans, holding that "this level of specificity is not required at the pleading stage." (a-6). In support of that holding, the Ninth Circuit quotes from another Ninth Circuit decision regarding Rule 9(b), *Moore v. Kayport Package Express, Inc.*, 885 F.2d 531, 540 (9th Cir. 1989). (a-6 to a-7).

6. Thus, contrary to respondents' claim, the Third Circuit's decision in *Shapiro* is not "completely consistent" with the Ninth Circuit's decision in this case. Opp. at 7 n.4.

banc decision will reach the Rule 12(b)(6) issues addressed in the *Wells Fargo* opinion. Although petitioners argued in the Petition for Rehearing *en banc* in the Ninth Circuit that the two panels' reliance on different rules did not eliminate the intra-circuit conflict, the Ninth Circuit rejected that argument by denying rehearing in *Wells Fargo*. Thus, the inter-circuit conflict created by the decision below is likely to remain unresolved, absent review by this Court.

Dated: August 4, 1994.

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